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COMMITTEE FOR EFFECTIVE CAPITAL RECOVERY

(formerly Ad Hoc Committee For An Effective Investment Tax Credit)

December 28, 1984

Mr. William J. Casey
Director
Central Intelligence Agency
Washington, D.C. 20505

Dear Mr. Casey:

I am writing to you on behalf of the Committee for Effective Capital Recovery, a group representing over 600 businesses around the country, which have been working for more than a decade to improve the incentives for savings and investment in our current tax system and thus to improve economic growth and employment in the United States.

As you know, the Treasury Department recently made public its long-anticipated tax reform plan. The Committee has carefully reviewed the various proposals contained in the Treasury report, and has studied the interaction and impact of these provisions. In so doing, full consideration was given to the positive aspects of the proposal, such as rate reduction and indexation for inflation. However, on balance, we are of the opinion that the recommendations to eliminate the investment tax credit, and to replace the Accelerated Cost Recovery System (ACRS) with a severely scaled-back system of depreciation, would be extremely detrimental to the nation's economy.

In analyzing the Treasury proposal, its effect on economic growth, not on a particular company or industry's taxes, is a paramount concern. Speaking now as the Chairman of Colt Industries Inc., a company that currently pays a high effective tax rate, I would like to point out that Colt's taxes would actually decrease under the Treasury proposal. However, we anticipate that the overall impact of the proposal on the nation's economic growth generally, and on Colt's ability to market its products, specifically, will be highly negative. Thus, the potential positive impact of the proposed lower tax rates will be negated by the reduced growth resulting from the elimination of investment incentives -- and reduced income, even if taxed at a lower rate, does nothing to increase profits.

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We have reached the conclusion that the Treasury proposal will be harmful to the economy based on a number of factors. First, history has already taught us much in this area. As the attached excerpt from the Committee's testimony to Congress in the mid-1970's pointed out,*/ the last two times Congress negatively changed the investment tax credit, there was a consequent severely damaging effect on the economy. Not only was there a sharp drop in new orders for machine tools and producer's capital goods, and a slowdown in employment in these industries, but there was also a decrease in total corporate federal tax revenues each time the credit was suspended or repealed. (See charts attached to excerpt of earlier Congressional Committee testimony.) This history provides an important lesson that should not be ignored in the rush to reform our tax system.

Second, from the information available to us, it appears that the very suggestion that the investment tax credit and ACRS might be repealed has already resulted in some contraction in business plans for investment. While Treasury has recommended a supposedly revenue-neutral tax plan, the fact is that cautious business managers cannot depend upon the tax rates actually decreasing to 33 percent. They will, however, take into consideration the negative proposals relating to capital investment incentives when planning future investments. Thus, the tax reform debate itself may freeze corporate spending plans.

The importance of stability in tax policy for the economy cannot be overstated. Back in the mid-1970's when a flexible investment credit was being proposed to respond to a changing economy, a serious analytical study**/ found that it was nearly impossible to optimally time the changes in the credit with the needs of the economy. Each of the historical changes in the credit was badly mistimed, coming about 10 quarters after the period during which they would have been most beneficial. It concluded that a fixed rate investment tax credit would have been much preferable to the changes actually made. A fluctuating credit is less efficient and, at times,

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*/ Statement of Committee for Effective Capital Recovery (formerly Ad Hoc Committee For An Effective Investment Tax Credit) before Senate Finance Committee, March 10, 1975, and House Ways and Means Committee, July 28, 1975.

**/ Policy Alternatives for the Investment Tax Credit by Roger H. Gordon, Princeton University and Dale W. Jorgensen, Harvard University (1975).

will be greater in amount and therefore more costly in the short run, than is necessary with a constant 10-percent credit.

After many years of this on-again, off-again tax policy, Congress finally realized the importance of stability when dealing with plant and equipment expenditures and adopted a "permanent" investment tax credit. Subsequently, ACRS was added as the centerpiece of our current system of corporate taxation in this area.

Studies of the impact of tax changes on the economy found that these capital investment incentives were among the most significant factors leading to the recent economic recovery. Since the depth of the 1981-82 recession, the rate of growth in fixed business investment has been the highest of any post-war recovery period. And productivity has increased for the ninth consecutive quarter, the longest period of productivity growth since 1966-68. In fact, 1984 is now expected to produce the largest real gain in economic growth since 1955, confirming the prediction of many economists that the country is in a period of sustained prosperity.

Despite this evidence of the enormous importance of the investment tax credit and ACRS, the Treasury Department concluded that these provisions were of limited value and that their elimination, combined with rate reductions, would more effectively lead to increased economic growth. Yet every independent study of the impact of the Treasury tax plan has reached the opposite conclusion.

Wharton Econometrics, a national forecasting firm, concluded that implementation of the Treasury tax reform proposal would result in higher consumption, lower capital stock, and, ultimately, decreased productivity. According to Wharton's senior economists, "[i]n 10 years, U.S. workers will be 0.6% less productive . . . [a]nd the gap will widen over time." The increased cost of capital and consequent decrease in productivity would result directly from the elimination of the investment tax credit and ACRS. Capital costs would increase by 15 percent in 1986, rising to 20 percent for manufacturing industries after 10 years.

The Wharton study concluded that the proposed rate reduction in the corporate tax could not offset this negative effect. It also found that the Treasury study would place the United States in a less competitive posture overseas. This finding was confirmed by a preliminary analysis of the plan by the National Association of Manufacturers which concluded that the Treasury plan will most likely have adverse effects on the international competitiveness of American industry because depreciation schedules would once again be less favorable than those available in other industrial countries.

In a similar vein, Data Resources, Inc. (DRI), also a major economic forecasting firm, predicts slower economic growth in the short run resulting from the Treasury Department's tax reform proposal. Cited as one of the major reasons for the slowdown was the elimination of the investment tax credit and accelerated depreciation. According to DRI, investment in equipment and structures would decline and not recover to their current baseline level until 1995. While total real spending would eventually increase slightly, DRI seriously questions whether the present economic climate is an appropriate one for making such drastic tax changes. The major risk of reducing per capita living standards due to sagging investments suggests to DRI that Congress should deal with the deficit before addressing tax reform.

These recent studies simply confirm some previous studies which lead to the same conclusion. For instance, a Washington University econometric analysis of the leading Congressional tax proposals, which also called for eliminating or changing the investment tax credit and ACRS (Bradley-Gephardt FAIR tax and Kemp-Roth FAST tax), found that the impact on the economy would be extremely adverse, despite the fact that each plan proposed a 16 point reduction in the corporate tax rate.

In a more general study of the impact of tax proposals on capital investment, the well-known economist, Allen Sinai, found that the current capital recovery provisions in the tax code provide a much greater "bang for the buck" than would a reduction in the corporate tax rate, that is, for each dollar of revenue lost in the short run, ACRS and the credit provide a greater economic benefit than a tax cut. For example, ACRS provides $0.81 in business fixed investment for every dollar of corporate tax lost, the investment tax credit provides $0.76, but a reduction in the corporate tax rate provides only $0.19.

All of these various economic studies lead to the same, inevitable conclusion -- ACRS and the investment tax credit are vital and necessary components of any tax plan intended to foster long-term, stable economic growth for this nation. A precipitous move to eliminate these incentives to capital investment could have a severely detrimental impact on productivity, employment, and balance of trade, and thus on the overall economic health of the country.

Thus, the Committee strongly urges that any proposal for tax reform maintain these crucial capital investment incentives.

Sincerely,

George A. Strichman

George A. Strichman
Chairman
Committee for Effective
Capital Recovery

Chairman of the Board
Colt Industries Inc.

EXCERPT FROM TESTIMONY OF
COMMITTEE FOR EFFECTIVE CAPITAL RECOVERY
(FORMERLY AD HOC COMMITTEE FOR AN
EFFECTIVE INVESTMENT TAX CREDIT)
BEFORE SENATE FINANCE COMMITTEE MARCH 10, 1975
AND HOUSE WAYS AND MEANS COMMITTEE JULY 28, 1975

HISTORIC EFFECTS OF CHANGES IN DEPRECIATION PROVISIONS AND THE INVESTMENT CREDIT

There is no question that liberalized depreciation provisions and the investment credit have proven in the past to be effective in increasing employment and productivity, thus combating inflation and enhancing real growth. This fact can be illustrated in terms of capital investments, employment and Federal revenues.

1. Effects of Changes in Capital Recovery Provisions on Investment in Capital Facilities, 1962-1972

Following enactment of the original investment credit and adoption of the reduced guideline lives for depreciation in 1962, new orders for machine tools increased rapidly by 251 percent--from $144 million in the last quarter of 1961 to $514 million in the first quarter of 1966. New orders for producers capital goods increased by 82 percent--from $8.9 billion in the fourth quarter of 1961 to $16.2 billion in the third quarter of 1966.

The suspension of the investment credit in the third quarter of 1966 was followed in the next two quarters by a sharp drop in new orders for machine tools and producers capital goods--$130 million and $2.8 billion, respectively.

Restoration of the credit in the second quarter of 1967 led to a rapid build up in orders--producers capital goods increased 36 percent from $13.8 billion in the first quarter of 1967 to $18.8 billion in the second quarter of 1969. Machine tool orders in the same period increased 70 percent from $328 million to $558 million.

The repeal of the credit in 1969 resulted in a drop of $2.7 billion in new orders for producers capital goods through the second quarter of 1970. Machine tool orders were off $417 million, almost 75 percent, from the second quarter of 1969 through the end of 1970.

Following enactment of the new investment credit and the Asset Depreciation Range (ADR) System in 1971, orders for producers capital goods increased by $4.5 billion from the second quarter of 1971 through the third quarter of 1972. Machine tool orders rose by $103 million--almost 60 percent-- in the same period, from $182 million to $285 million. The pattern is unmistakable.

2. Employment Effects, 1962-1972

Employment in capital goods and machine tool manufacturing industries in 1962-1972 also parallels changes in capital recovery tax provisions. Following enactment of the investment credit and adoption of the shorter guideline lives for depreciation in 1962, the number of employees in producers durable goods industries increased rapidly by 23 percent from 6.1 million in 1962 to 7.5 million in 1966. Suspension of the credit in the third quarter of 1966 slowed employment increases to only 2 2/3 percent in 1967. Following restoration of the credit in the second quarter of 1967, employment increased to about 8 million in 1969.

With the repeal of the credit in 1969, employment dropped by about 900,000 jobs--roughly 11 1/4 percent--in 1971. After enactment of the new credit and the ADR in 1971, employment increased from 7.1 million to 7.8 million--about 10 percent--in 1973.

The number of employees in machine tool manufacturing rose by 41 percent or 34,000 from 1962 through 1967. Output and employment in this industry was adversely affected by the cutback in the space program in 1968; between 1967 and 1969, employment dropped by 5 percent or 5,800 jobs. Repeal of the investment credit in 1969 resulted in a much steeper drop in jobs, from 110,600 in 1969 to 78,400 in 1971, a decline of 29 percent. After enactment of the new credit and the ADR in 1971, machine tool employment increased by 3,700 jobs or by 4.7 percent in 1972.

The above discussion covers the capital goods sector only. Through the multiplier effect, the beneficial impact of the credit on employment in the capital goods sector was also reflected in higher employment throughout the economy.

3. Revenue Effects of Changes in Capital Recovery Allowances, 1962-1972

The investment tax credit and the shortening of tax lives have added an estimated $2.6 billion to Federal tax collections from all sources since 1962. In every year that the investment tax credit was in effect, Federal revenues were above the level they would otherwise have been, amounting to approximately $1 billion in 1972 alone.

Conversely, tax receipts fell each time the credit was removed. Suspension of the credit in 1966-67 and its repeal from 1969 until 1971 resulted in a $760 million decrease in Federal tax revenues below what would otherwise have been collected had the credit remained in effect.

These estimates follow from a calculation of the amount by which tax changes altered the cost of capital outlays resulting from enactment of the credit and issuance of the guideline lives in 1962, removal of the basis adjustment in 1964, suspension of the tax credit for two quarters in 1966 and 1967, its restoration in 1967, repeal in 1969 and reinstatement and approval of the Asset Depreciation Range in 1971. Each favorable change raised output, wages and profits, thereby expanding the Federal tax base. Conversely, each tax law change which increased the cost of capital outlays resulted in a lower level of output, wages and profits than would otherwise have occured.

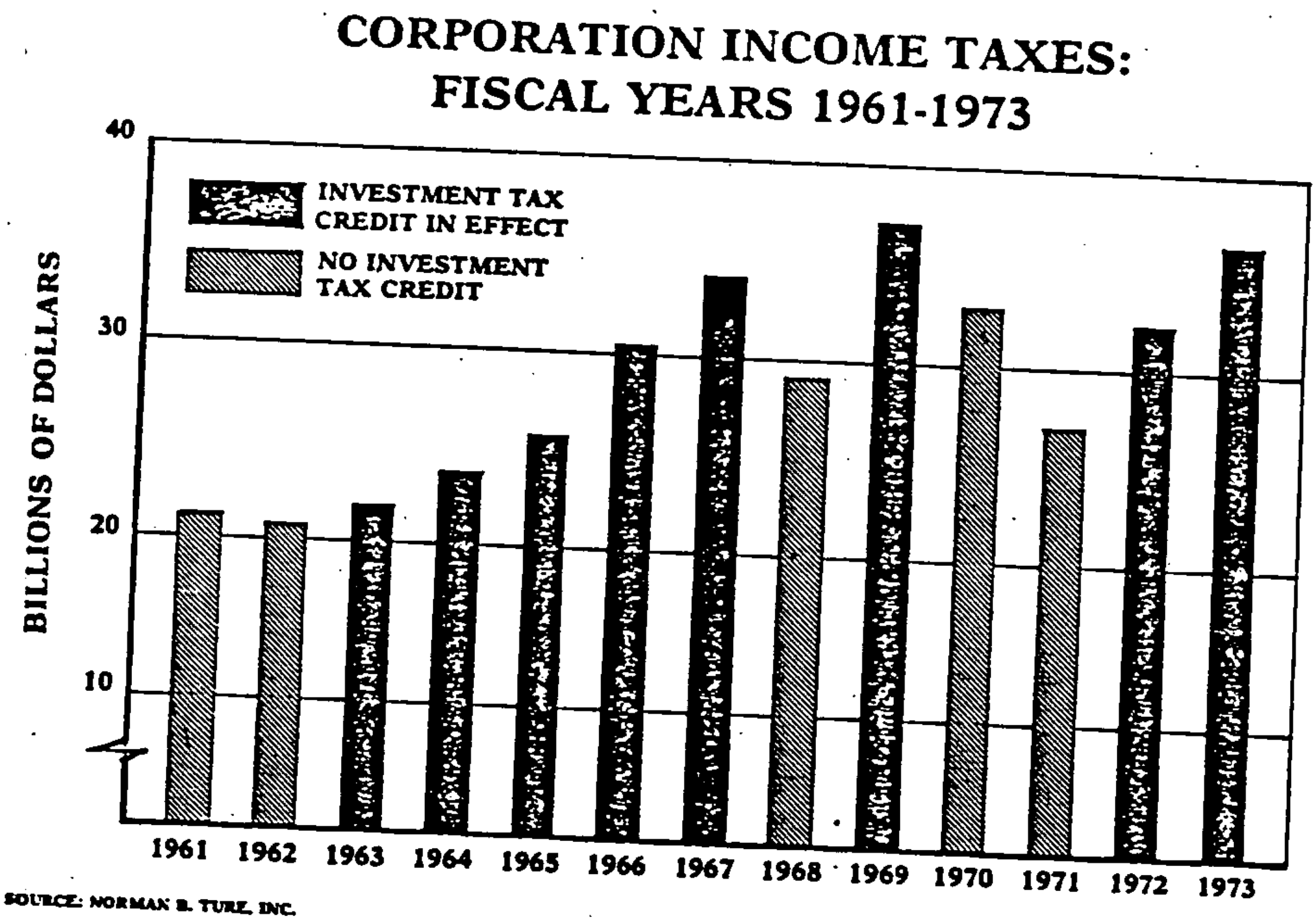

Table A. Estimated Change in Federal Revenues Resulting From Tax Credit and Shorter Tax Lives, 1962-72 (Calendar Years)

Year	Revenue Change (Millions of dollars)	
1962	160	
1963	330	
1964	50	
1965	110	
1966		- 50
1967	140	
1968	390	
1969		-230
1970		-480
1971	440	
1972	1,000	
Total	2,620	-760
Net Change*	1870	

*Note: Net change differs from sum of individual changes shown due to rounding.

Source: Norman B. Ture, Inc.

The patterns of fluctuations in these key areas demonstrate:

1. that the investment credit accomplishes what its original proponents intended; and

2. that it can be fully effective in stimulating needed, long-term growth only if its basic provisions (particularly the rate of the credit) are permanent features of the tax code.

Approved For Release 2008/10/31 : CIA-RDP86M00886R002000100005-7

Chart 1.

PRODUCER'S CAPITAL GOODS: NET NEW ORDERS
(Quarterly in Billions of Dollars)